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Reinsurers Brace for 'Triggers'

Reductions in Financial Ratings, Like Those That Hit Converium, Can Spark an Exodus of Clients

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PARIS -- **Converium** AG, one of the world's largest reinsurance companies, already was having problems. Then last month came the crisis: a one-notch downgrade in the rating on its financial security.

Why did a simple downgrade trigger a crisis? The reason: Converium's own, trigger-happy insurance clients.

In a spiral of events that is full of irony, when Converium's rating slipped, several of those insurers -- who contract with the Swiss reinsurer to pay some of their policyholders' claims -- yanked their business. The insurance companies were able to do so because of "triggers" in their contracts that allowed them to dump the reinsurer, rated single-A as recently as July, when its rating dropped last month to triple-B.

MAKING THE GRADE

The world's 10 largest reinsurance companies and their net reinsurance premiums for 2003.

COMPANY	PREMIUMS (IN BILLIONS)	CURRENT S&P CREDIT RATING	OUTLOOK
Munich Re	$29.20	A+	Stable
Swiss Re	24.78	AA	Negative
Berkshire Hathaway Re	11.95	AAA	Stable
Employers Re	9.73	A+	Negative
Hannover Re	8.70	AA-	Stable
Lloyd's	7.82	A	Stable
Allianz Re	5.23	AA-	Negative
Scor	4.26	BBB+	Stable
Converium	3.83	BBB	Positive*
Partner Re	3.59	AA-	Stable

Reinsurers are the world's deep-pocketed insurers of last resort, whose clients are the better-known insurance companies that sell policies to individuals and corporations. Insurers pay reinsurers to assume some of the risk of the policies they sell. Now, many of the world's other large reinsurers are not far from thresholds that could trigger a similar rush for the exits by clients.

That is causing concern that the common use of trigger clauses in reinsurance contracts could be a flaw in the system. Among those most troubled by the trend: Ratings companies themselves, which warn that triggers can push struggling reinsurance companies over the edge of what the industry calls "a ratings cliff."

"The existence of triggers in contracts can be dangerous," says Stephen Searby, reinsurance analyst with Standard & Poor's in London, because they can provoke "a sudden and potentially fatal liquidity crunch."

Trigger clauses allow clients to withdraw their business, usually demanding that a portion of the "premiums" they paid to the reinsurer be returned, or require the reinsurer to post collateral to help cover claims the insurers may present later for payment.

Ratings on corporate debt long have been a part of how investors view companies, helping to determine the price at which companies can raise funds. They also long have been recognized as important in the reinsurance business. There, liabilities can extend over decades, and ratings give investors and clients an indication of a reinsurer's ability to meet its obligations.

Triggers are reassuring to insurers amid increasingly costly insurance claims from natural catastrophes and settlements to resolve litigation, including decades-old asbestos claims.

"When you buy a reinsurance contract, you're buying security and a promise to pay," says Rory Barker, group reinsurance manager for London-based insurer **Hiscox** PLC. "If that security changes part way through the year, you want the option to terminate the contract if necessary." He declines to discuss Hiscox's specific contracts, but says that such clauses are standard in its reinsurance coverage.

One of the world's largest buyers of reinsurance coverage, **American International Group** Inc., says it long has insisted on trigger clauses, known as "special termination clauses."

The Long View

"Rating agencies give you a three- to five-year view," says Christian Milton, AIG's vice president for reinsurance. Because AIG's claims could be 10 years to four decades down the road, "we need the additional security."

For their part, reinsurers tend to resist the clauses. Giants **Swiss Reinsurance** Co. and **Munich Re** AG tell their underwriters, for example, that most trigger clauses are "unacceptable." But when the annual negotiating season for renewing reinsurance contracts kicks off later this month, with about $165 billion in premiums at play, "ratings triggers will be on the table," Clement Booth, head of reinsurance broker Aon Re, told an industry conference in Monte Carlo, Monaco, last month. "There's a lot of pressure to get them into the contract." Reinsurance brokers act as advisers to insurers looking for reinsurance cover.

The speed at which Converium spun into its crisis provides insight into why insurers are eager to obtain trigger clauses, and how those same clauses can exacerbate a crisis.

In early June, Converium was apparently sailing steady. On June 3, S&P confirmed its single-A rating and said the outlook was stable. Six weeks later, after Converium surprised investors with news of higher-than-expected claims on its U.S. property-and-casualty policies from 1997 to 2001, several rating services slapped it with downgrades, including a cut to single-A-minus from S&P.

Ratings Cut

In early September, as the size of the company's reserving requirements became apparent, the rating services moved again. The coup de grace came from S&P, which expressed concerns on Sept. 10 about the "credibility of Converium's management" and its ability to attract new business.

The ratings service dropped Converium to triple-B, below the single-A-minus threshold typically cited in trigger clauses.

"One reason that trigger clauses are becoming so much more popular is that there are questions about the reliability and stability of commercial ratings, as downgrades can happen quickly and without warning despite the rating agencies' privileged access to nonpublic information," says Chris Klein, head of counterparty risk at Benfield Group, a London-based insurance and reinsurance broker.

Raising Capital

Within days of its downgrade, Converium saw a substantial chunk of its business walk out the door. U.K. motor insurer **Admiral Group** PLC, for example, says it moved business valued at $60 million in annual premiums for next year, and now is splitting the business between **Berkshire Hathaway** Inc.'s General Re unit and Axis Re Europe, which is part of Bermuda-based **Axis Capital Group Holdings**.

Forced to close its U.S. operation, Converium set in motion a plan to raise $420 million in capital from shareholders at a deep discount.

It expects to write half the amount of business next year as it does this year. After securing shareholder approval for the new capital late last month, Converium said it expects to return to profitability, record rising premium volume and regain its A-category rating in 2006. It declines additional comment now because it is in a quiet period tied to raising that capital.

Insurance regulators also are starting to look at the potential impact of downgrade-related trigger clauses. Yoshi Kawai, secretary general of the International Association of Insurance Supervisors, says the issue was discussed at a meeting of the association's reinsurance committee last week. "We are interested in this issue but have not yet agreed on any specific action," he says.

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